
APPENDIX 61 (TRANSFER PRICING FOR ROYALTIES)

Material:

Information Circular 87-2R – International Transfer Pricing, paragraphs 139-151

OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chapter VI, paragraphs 6.1-6.39

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Part 5. Intangible Property

139. Applying the arm's length principle to transfers of intangible property raises specific issues associated with the difficulty and uncertainty sometimes encountered with attributing an arm's length value to such transfers. In most cases, both the supplier and the recipient share the risks and the benefits associated with using an intangible.

140. Arm's length pricing for the transfer of intangible property must take into account the perspective of both the transferor of the property and the transferee. A transferor attempts to recover the costs associated with developing an intangible and to earn a reasonable return. However, to the recipient, the value of an intangible is based solely on the expected benefits (additional profits) that the intangible would generate. The overall expected benefit to the recipient is usually a key consideration in determining the transfer price of an intangible to both parties.

For example, in most cases, an arm's length exclusive distributor of a product would only agree to pay a higher royalty for the use of a highly valuable brand name if the use of such brand-name is expected to generate profits, for the distributor, which are higher than those that the distributor would have expected if it had distributed a similar product without the brand-name intangible.

141. The very nature of intangible property may often make its valuation difficult. The inherent risk often associated with intangible property may produce significant fluctuations in their value. In addition, intangible property may be of significant value even though it has no or little book-value in the taxpayer's balance sheet.

142. It may be very difficult to find intangibles which are comparable. In applying the arm's length principle to transactions involving intangibles, the most appropriate transfer pricing method will be the one that provides the highest degree of comparability between transactions.

143. Where comparable data on an intangible exists, the most appropriate transaction method is a traditional one (i.e., CUP or resale price). It may be possible to use the CUP method to determine an arm's length price for the sale or license of an intangible property (such as a patent, a trademark, or know-how) where the same or a comparable intangible property has been sold or licensed to arm's length parties.

144. Genuine offers from arm's length parties for the intangible may also be taken into account. However, where such an offer does not result in an agreement between the parties, taxpayers should also consider the factors leading to the

rejection of the offer. An offer made by a potential purchaser may be representative of a price that the particular purchaser was prepared to pay. However, it may not be representative of the price that a vendor is prepared to accept.

145. Traditional transaction methods or the TNMM would probably not be appropriate where an intangible property is highly valuable or unique, such as a patent resulting from risky and costly research and development because of the difficulty in finding comparable information.

Furthermore, to the extent that excess profits are generated by a highly valuable or unique intangible, it would be unusual that all the excess profits would accrue to either the supplier or the user of the intangible. In such cases, the residual profit split method may often be the most appropriate method.

146. In determining a transfer price for an intangible, whether for sale or for use, a taxpayer must consider the terms and conditions that arm's length parties would insist on to protect their respective positions.

For example, where the value of an intangible is uncertain, one needs to consider whether an arm's length transferor would permit the long-term exploitation of the intangible by an arm's length party.

As protection, an arm's length transferor may insist on an agreement that:

- has a relatively short term;
- includes a price adjustment clause; or
- sets variable royalty rates tied to profits.

If the exploitation of the intangible proves highly profitable, the transferor would enjoy a reasonable share of that financial success.

Similarly, an arm's length transferee, wishing to exploit an intangible property, may not agree to pay large amounts for the exclusive use of the property for a long period of time, if the value of the intangible is uncertain. In such circumstances, transferees may negotiate a short-term contract, a price adjustment clause, or variable royalty rates tied to profits.

147. Where a royalty rate is being established, a taxpayer should consider:

- prevailing industry rates;
- terms of the agreement, including geographic limitations, time limitations, and exclusivity rights;
- singularity of the invention and the period for which it is likely to remain unique;
- technical assistance, trademarks, and know-how provided along with access to any patent;
- profits anticipated by the licensee; and
- benefits to the licensor arising from sharing information on the experience of the licensee.

148. Taxpayers who do not own trademarks or trade names sometimes undertake marketing activities. In these instances, the issue arises as to whether they should share in any return attributable to the marketing intangibles. Distributors who bear the costs of marketing activities would usually expect to share in the return from the marketing intangibles. As well, distributors who bear marketing costs in excess of those that an arm's length distributor with similar rights to exploit the intangible would incur, would expect an additional return from the owner of the trademark or trade name. The actual marketing activities of the distributor over a number of years should be given significant weight in evaluating the return attributable to marketing activities.

149. Despite the difficulty in determining a transfer price for intangibles, using hindsight to determine their value is not appropriate. Under the arm's length principle, an agreement that is, in substance, the same as one into which arm's length parties would have entered, would not usually be subject to adjustment by a tax administration as a result of subsequent events. Therefore, it would be inconsistent with the arm's length principle for a tax administration to require, or accept, an adjustment solely on the basis that income streams or cost savings differ from those initially estimated by the parties. However, the Department may consider factors that a reasonable person with some knowledge of the industry would have taken into account at the time the valuation was projected.

150. As outlined in paragraph 43 of this circular, the Department generally accepts business transactions as they are structured by the parties. However, the OECD Guidelines identify two types of situations where the recharacterization of a transaction would be considered. One situation identified by the OECD is a sale under a long-term contract, for a lump sum payment, of unlimited entitlement to intangible property arising as a result of future research.

151. The Department will review any long-term agreements between non-arm's length parties for the right to use intangibles to ensure that they are consistent with the arm's length principle. Paragraph 247(2)(*b*) provides for an adjustment where the Department determines that:

- a long-term sale of intangible property would not have been entered into between persons dealing at arm's length; and

- the sale was not entered into primarily for bona fide purposes other than to obtain a tax benefit.

For example, it may be appropriate in such a situation for the Department to modify the amounts for purposes of the Act on the basis of an alternative transaction whose form, nature, terms, and conditions correspond to what arm's length parties would have agreed to-to reflect an ongoing research agreement.

TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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- to contribute to sound economic expansion in Member as well as non-member countries in the process of economic development; and
- to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.

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Chapter VI

Special Considerations for Intangible Property

A. Introduction

6.1 This Chapter discusses special considerations that arise in seeking to establish whether the conditions made or imposed in transactions between associated enterprises involving intangible property reflect arm's length dealings. Particular attention to intangible property transactions is appropriate because the transactions are often difficult to evaluate for tax purposes. The Chapter discusses the application of appropriate methods under the arm's length principle for establishing transfer pricing for transactions involving intangible property used in commercial activities, including marketing activities. It also discusses specific difficulties that arise when the enterprises conducting marketing activities are not the legal owners of marketing intangibles such as trademarks and tradenames. Cost contribution arrangements among associated enterprises for research and development expenditures that may result in intangible property will be discussed in Chapter VIII.

6.2 For the purposes of this Chapter, the term "intangible property" includes rights to use industrial assets such as patents, trademarks, trade names, designs or models. It also includes literary and artistic property rights, and intellectual property such as know-how and trade secrets. This Chapter concentrates on business rights, that is intangible property associated with commercial activities, including marketing activities. These intangibles are assets that may have considerable value even though they may have no book value in the company's balance sheet. There also may be considerable risks associated with them (e.g., contract or product liability and environmental damages).

B. Commercial intangibles

i) In general

6.3 Commercial intangibles include patents, know-how, designs, and models that are used for the production of a good or the provision of a service, as well as intangible rights that are themselves business assets transferred to customers or used in the operation of business (e.g., computer software). Marketing

intangibles are a special type of commercial intangible with a somewhat different nature, as discussed below. For purposes of clarity, commercial intangibles other than marketing intangibles are referred to as trade intangibles. Trade intangibles often are created through risky and costly research and development (R&D) activities, and the developer generally tries to recover the expenditures on these activities and obtain a return thereon through product sales, service contracts, or licence agreements. The developer may perform the research activity in its own name, i.e. with the intention of having legal and economic ownership of any resulting trade intangible, on behalf of one or more other group members under an arrangement of contract research where the beneficiary or beneficiaries have legal and economic ownership of the intangible, or on behalf of itself and one or more other group members under an arrangement in which the members involved are engaged in a joint activity and have economic ownership of the intangible (also discussed in Chapter VIII on cost contribution arrangements). Reciprocal licensing (cross-licensing) is not uncommon, and there may be other more complicated arrangements as well.

6.4 Marketing intangibles include trademarks and tradenames that aid in the commercial exploitation of a product or service, customer lists, distribution channels, and unique names, symbols, or pictures that have an important promotional value for the product concerned. Some marketing intangibles (e.g., trademarks) may be protected by the law of the country concerned and used only with the owner's permission for the relevant product or services. The value of marketing intangibles depends upon many factors, including the reputation and credibility of the tradename or the trademark fostered by the quality of the goods and services provided under the name or the mark in the past, the degree of quality control and ongoing R & D, distribution and availability of the goods or services being marketed, the extent and success of the promotional expenditures incurred in order to familiarize potential customers with the goods or services (in particular advertising and marketing expenditures incurred in order to develop a network of supporting relationships with distributors, agents, or other facilitating agencies), the value of the market to which the marketing intangibles will provide access, and the nature of any right created in the intangible under the law.

6.5 Intellectual property such as know-how and trade secrets can be trade intangibles or marketing intangibles. Know-how and trade secrets are proprietary information or knowledge that assists or improves a commercial activity, but that

is not registered for protection in the manner of a patent or trademark. The term know-how is perhaps a less precise concept. Paragraph 11 of the Commentary on Article 12 of the OECD Model Tax Convention gives the following definition: "Know-how is all the undivulged technical information, whether capable of being patented or not, that is necessary for the industrial reproduction of a product or process, directly and under the same conditions; in as much as it is derived from experience, know-how represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique." Know-how thus may include secret processes or formulae or other secret information concerning industrial, commercial or scientific experience that is not covered by patent. Any disclosure of know-how or a trade secret could substantially reduce the value of the property. Know-how and trade secrets frequently play a significant role in the commercial activities of MNE groups.

6.6 Care should be taken in determining whether or when a trade or marketing intangible exists. For example, not all research and development expenditures produce a valuable trade intangible, and not all marketing activities result in the creation of a marketing intangible. It can be difficult to evaluate the degree to which any particular expenditure has successfully resulted in a business asset and to calculate the economic effect of that asset for a given year.

6.7 For example, marketing activities may encompass a wide range of business activities, such as market research, designing or planning products suitable to market needs, sales strategies, public relations, sales, service, and quality control. Some of these activities may not have an impact beyond the year in which they are performed, and so would properly be treated as current expenses rather than as capitalisable expenditures. Other activities may have both short-term and long-term effect. The treatment of such activities is likely to be important in a functional analysis carried out in order to establish comparability for the purposes of transfer pricing. In some cases, the costs of marketing activities and, with respect to trade activities, R&D expenditures, may be sought to be recovered through the charging for associated goods and services, whereas in other cases there may have been created intangible property on which a royalty is separately charged, or a combination of the two.

ii) Examples: patents and trademarks

6.8 The differences between trade and marketing intangibles can be seen in a comparison of patents and trademarks. Patents are basically concerned with the production of goods (which may be sold or used in connection with the provision of services) while trademarks are used in promoting the sale of goods or services. A patent gives an exclusive right to its owner to use a given invention for a limited period of time. A trademark may continue indefinitely; its protection will disappear only under special circumstances (voluntary renunciation, no renewal in due time, cancellation or annulment following a judicial decision, etc.). A trademark is a unique name, symbol or picture that the owner or licensee may use to identify special products or services of a particular manufacturer or dealer and, as a corollary, to prohibit their use by other parties for similar purposes under the protection of domestic and international law. Trademarks may confer a valuable market status on the goods or services to which they are attached, whether or not those goods or services are otherwise unique. Patents may create a monopoly in certain products or services whereas trademarks alone do not, because competitors may be able to sell the same or similar products so long as they use different distinctive signs.

6.9 Patents are usually the result of risky and costly research and development and the developer will try to recover its costs (and earn a return) through the sale of products covered by the patent, licensing others to use the invention (often a product or process), or through the outright sale of the patent. The legal creation of a new trademark (or one newly introduced to a given market) is usually not an expensive matter. In contrast, it will very often be an expensive business to make it valuable and to ensure that the value is maintained (or increased). Intensive and costly advertising campaigns and other marketing activities will ordinarily be necessary as will expenditure on the control of the quality of the trademarked product. The value and any changes will depend to an extent on how effectively the trademark is promoted in the markets in which it is used. Value will also depend on the reputation of the owner for quality in production and rendering of services and on how well this reputation is maintained. In certain cases, the value for the licensor may increase as the result of efforts and expenditure by the licensee. In some cases patents, because of their outstanding quality, may also have a very strong marketing effect similar to that of a pure trademark and payments for the right to use such patents may have to be looked at in much the same light as payments for the right to use a trademark.

6.10 Trademarks may be established for goods, either for specific products or for a line of products. They are perhaps most familiar at the consumer market level, but they are likely to be encountered at all market levels. Trademarks may also be acquired for services. The ownership of a trademark would normally be vested in one person, for example, a legally independent company. A trade name (often the name of an enterprise) may have the same force of penetration as a trademark and may indeed be registered in some specific form as a trademark. The names of certain multinational enterprises in pharmaceutical or electronic industries, for example, have an excellent sales promotion value, and they may be used for the marketing of a variety of goods or services. The names of well-known persons, designers, sports figures, actors, people working in show business, etc., may also be associated with trade names and trademarks, and they have often been very successful marketing instruments.

6.11 A trademark may be sold, licensed, or otherwise transferred by one person to another. Various kinds of license contracts are concluded in practice. A distributor could be allowed to use a trademark without a licence agreement in selling products manufactured by the owner of the trademark, but trademark licensing also has become a common practice, particularly in international trade. Thus, the owner of a trademark may grant a licence to the trademark to another enterprise to use for goods that it produces itself or buys from other sources (or from the licensor, e.g., where goods or components are purchased generically in a separate transaction without a trademark). The terms and conditions of license agreements may vary to a considerable extent.

6.12 It is sometimes difficult to make a clear-cut distinction between income from trade and marketing intangibles. For instance, in research-oriented industries, the trademark and tradename are vital components in securing sufficient income to reward past research and undertake new projects, particularly as patents are time-limited. Building up brand confidence and trademark recognition is therefore vitally important to ensure that the product continues to be commercially viable after the patent expires or even in cases where no patent was developed. See Section D describing arm's length arrangements involving marketing intangibles.

C. Applying the arm's length principle

i) In general

6.13 The general guidance set out in Chapters I, II, and III for applying the arm's length principle pertains equally to the determination of transfer pricing between associated enterprises for intangible property. This principle can, however, be difficult to apply to controlled transactions involving intangible property because such property may have a special character complicating the search for comparables and in some cases making value difficult to determine at the time of the transaction. Further, for wholly legitimate business reasons due to the relationship between them, associated enterprises might sometimes structure a transfer in a manner that independent enterprises would not contemplate (See Chapter I, paragraphs 1.10 and 1.36).

6.14 Arm's length pricing for intangible property must take into account for the purposes of comparability the perspective of both the transferor of the property and the transferee. From the perspective of the transferor, the arm's length principle would examine the pricing at which a comparable independent enterprise would be willing to transfer the property. From the perspective of the transferee, a comparable independent enterprise may or may not be prepared to pay such a price, depending on the value and usefulness of the intangible property to the transferee in its business. The transferee will generally be prepared to pay this license fee if the benefit it reasonably expects to secure from the use of the intangibles is satisfactory having regard to other options realistically available. Given that the licensee will have to undertake investments or otherwise incur expenditures to use the licence it has to be determined whether an independent enterprise would be prepared to pay a licence fee of the given amount considering the expected benefits from the additional investments and other expenditures likely to be incurred.

6.15 This analysis is important to ensure that an associated enterprise is not required to pay an amount for the purchase or use of intangible property that is based on the highest or most productive use when the property is of more limited usefulness to the associated enterprise given its business operations and other relevant circumstances. In such a case, the usefulness of the property should be taken into account when determining comparability. This discussion highlights

the importance of taking all the facts and circumstances into consideration when determining comparability of transactions.

ii) Identifying arrangements made for the transfer of intangible property

6.16 The conditions for transferring intangible property may be those of an outright sale of the intangible or, more commonly, a royalty under a licensing arrangement for rights in respect of the intangible property. A royalty would ordinarily be a recurrent payment based on the user's output, sales, or in some rare circumstances, profits. When the royalty is based on the licensee's output or sales, the rate may vary according to the turnover of the licensee. There are also instances where changed facts and circumstances (e.g., new designs, increased advertising of the trademark by the owner) could lead to a revision of the conditions of remuneration.

6.17 The compensation for the use of intangible property may be included in the price charged for the sale of goods when, for example, one enterprise sells unfinished products to another and, at the same time, makes available its experience for further processing of these products. Whether it could be assumed that the transfer price for the goods includes a licence charge and that, consequently, any additional payment for royalties would ordinarily have to be disallowed by the country of the buyer, would depend very much upon the circumstances of each deal and there would appear to be no general principle which can be applied except that there should be no double deduction for the provision of technology. The transfer price may be a package price, i.e., for the goods and for the intangible property, in which case, depending on the facts and circumstances, an additional payment for royalties may not need to be paid by the purchaser for being supplied with technical expertise. This type of package pricing may need to be disaggregated to calculate a separate arm's length royalty in countries that impose royalty withholding taxes.

6.18 In some cases, intangible property will be bundled in a package contract including rights to patents, trademarks, trade secrets, and know-how. For example, an enterprise may grant a licence in respect of all the industrial and intellectual properties it owns. The parts of the package may need to be considered separately to verify the arm's length character of the transfer (see paragraph 1.43 of Chapter I). It also is important to take into account the value

of services such as technical assistance and training of employees that the developer may render in connection with the transfer. Similarly, benefits provided by the licensee to the licensor by way of improvements to products or processes may need to be taken into account. These services should be evaluated by applying the arm's length principle, taking into account the special considerations for services described in Chapter VII. It may be important in this respect to distinguish between the various means of making know-how available. Guidance on these issues is provided by paragraph 11 of the Commentary on Article 12 of the OECD Model Tax Convention.

6.19 A know-how contract and a service contract may be dealt with differently in a particular country according to its internal tax legislation or to the tax treaties it has concluded with other countries. This issue is one which will be given further attention from the Working Party No. 1 on Double Taxation and Related Questions. For example, whether or not a withholding tax is levied on payments made to non-residents may depend on the way the contract is viewed. If the payment is seen as service fees, it is usually not taxed in the country of origin unless the receiving enterprise carries on business in that country through a permanent establishment situated therein and the fee is attributable to the permanent establishment. On the other hand, royalties paid for the use of intangible property are subject to a withholding tax in some countries.

iii) Calculation of an arm's length consideration

6.20 In applying the arm's length principle to controlled transactions involving intangible property, some special factors relevant to comparability between the controlled and uncontrolled transactions should be considered. These factors include the expected benefits from the intangible property (possibly determined through a net present value calculation). Other factors include: any limitations on the geographic area in which rights may be exercised; export restrictions on goods produced by virtue of any rights transferred; the exclusive or non-exclusive character of any rights transferred; the capital investment (to construct new plants or to buy special machines), the start-up expenses and the development work required in the market; the possibility of sub-licensing, the licensee's distribution network, and whether the licensee has the right to participate in further developments of the property by the licensor.

6.21 When the intangible property involved is a patent, the analysis of comparability should also take into account the nature of the patent (e.g. product or process patent) and the degree and duration of protection afforded under the patent laws of the relevant countries, bearing in mind that new patents may be developed speedily on the basis of old ones, so that the effective protection of the intangible property may be prolonged considerably. Not only the duration of the legal protection but also the length of the period during which patents are likely to maintain their economic value is important. An entirely new and distinctive "breakthrough" patent may make existing patents rapidly obsolete and will command a higher price than one either designed to improve a process already governed by an existing patent or one for which substitutes are readily available.

6.22 Other factors for patents include the process of production for which the property is used, and the value that the process contributes to the final product. For example, where a patented invention covers only one component of a device, it could be inappropriate to calculate the royalty for the invention by reference to the selling price for the complete product. In such a case, a royalty based on a proportion of the selling price would have to take into account the relative value of the component to the other components of the product. Also, in analysing functions performed (including assets used and risks assumed) for transactions involving intangible property, the risks considered should include product and environmental liability, which have become increasingly important.

6.23 In establishing arm's length pricing in the case of a sale or licence of intangible property, it is possible to use the CUP method where the same owner has transferred or licensed comparable intangible property under comparable circumstances to independent enterprises. The amount of consideration charged in comparable transactions between independent enterprises in the same industry can also be a guide, where this information is available, and a range of pricing may be appropriate. Offers to unrelated parties or genuine bids of competing licensees also may be taken into account. If the associated enterprise sub-licenses the property to third parties, it may also be possible to use some form of the resale price method to analyse the terms of the controlled transaction.

6.24 In the sale of goods incorporating intangible property, it may also be possible to use the CUP or resale price method following the principles in Chapter II. When marketing intangibles (e.g. a trademark) are involved, the

analysis of comparability should consider the value added by the trademark, taking into account consumer acceptability, geographical significance, market shares, sales volume, and other relevant factors. When trade intangibles are involved, the analysis of comparability should moreover consider the value attributable to such intangibles (patent protected or otherwise exclusive intangibles) and the importance of the ongoing R&D functions.

6.25 For example, it may be the case that a branded athletic shoe transferred in a controlled transaction is comparable to an athletic shoe transferred under a different brand name in an uncontrolled transaction both in terms of the quality and specification of the shoe itself and also in terms of the consumer acceptability and other characteristics of the brand name in that market. Where such a comparison is not possible, some help also may be found, if adequate evidence is available, by comparing the volume of sales and the prices chargeable and profits realised for trademarked goods with those for similar goods that do not carry the trademark. It therefore may be possible to use sales of unbranded products as comparable transactions to sales of branded products that are otherwise comparables, but only to the extent that adjustments can be made to account for any value added by the trademark. For example, branded athletic shoe "A" may be comparable to an unbranded shoe in all respects (after adjustments) except for the brandname itself. In such a case, the premium attributable to the brand might be determined by comparing an unbranded shoe with different features, transferred in an uncontrolled transaction, to its branded equivalent, also transferred in an uncontrolled transaction. Then it may be possible to use this information as an aid in determining the price of branded shoe "A", although adjustments may be necessary for the effect of the difference in features on the value of the brand. However, adjustments may be particularly difficult where a trademarked product has a dominant market position such that the generic product is in essence trading in a different market, particularly where sophisticated products are involved.

6.26 In cases involving highly valuable intangible property, it may be difficult to find comparable uncontrolled transactions. It therefore may be difficult to apply the traditional transaction methods and the transactional net margin method, particularly where both parties to the transaction own valuable intangible property or unique assets used in the transaction that distinguish the transaction from those of potential competitors. In such cases the profit split method may be relevant although there may be practical problems in its application.

6.27 In assessing whether the conditions of a transaction involving intangible property reflect arm's length dealings, the amount, nature, and incidence of the costs incurred in developing or maintaining the intangible property might be examined as an aid to determining comparability or possibly relative value of the contributions of each party, particularly where a profit split method is used. However, there is no necessary link between costs and value. In particular, the actual fair market value of intangible property is frequently not measurable in relation to the costs involved in developing and maintaining the property. One reason is that intangible property, such as patents and know-how, may be the result of long-lasting and expensive R&D. The actual size of R&D budgets depends on a variety of factors, including the policy of competitors or potential competitors, the expected profitability of the research activity, and the trend of profits; or considerations based on some relation to turnover, or an assessment of the yield from R&D activity in the past as a basis for fixing future expenditure levels. R&D budgets may be sought to be covered by product sales even though the products in question may not be a direct or even perhaps an indirect result of the R&D. Another reason is that intangible property may require ongoing R&D and quality control that may benefit a range of products.

iv) Arm's length pricing when valuation is highly uncertain at the time of the transaction

6.28 As stated at the outset of this section, intangible property may have a special character complicating the search for comparables and in some cases making value difficult to determine at the time of a controlled transaction involving the property. When valuation of intangible property at the time of the transaction is highly uncertain, the question is raised how arm's length pricing should be determined. The question should be resolved, both by taxpayers and tax administrations, by reference to what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction.

6.29 Depending on the facts and circumstances, there are a variety of steps that independent enterprises might undertake to deal with high uncertainty in valuation when pricing a transaction. One possibility is to use anticipated benefits (taking into account all relevant economic factors) as a means for establishing the pricing at the outset of the transaction. In determining the anticipated benefits, independent enterprises would take into account the extent

to which subsequent developments are foreseeable and predictable. In some cases, independent enterprises might find that the projections of anticipated benefits are sufficiently reliable to fix the pricing for the transaction at the outset on the basis of those projections, without reserving the right to make future adjustments.

6.30 In other cases, independent enterprises might not find that pricing based on anticipated benefits alone provides an adequate protection against the risks posed by the high uncertainty in valuing the intangible property. In such cases, independent enterprises might adopt shorter-term agreements or include price adjustment clauses in the terms of the agreement, to protect against subsequent developments that might not be predictable. For example, a royalty rate could be set to increase as the sales of the licensee increase.

6.31 Also, independent enterprises may determine to bear the risk of unpredictable subsequent developments to a certain degree, however with the joint understanding that major unforeseen developments changing the fundamental assumptions upon which the pricing was determined would lead to the renegotiation of the pricing arrangements by mutual agreement of the parties. For example, such renegotiation might occur at arm's length if a royalty rate based on sales for a patented drug turned out to be vastly excessive due to an unexpected development of an alternative low-cost treatment. The excessive royalty might remove the incentive of the licensee to manufacture the drug at all, in which case the agreement might be renegotiated (although whether this in fact would happen would depend upon all the facts and circumstances).

6.32 When tax administrations evaluate the pricing of a controlled transaction involving intangible property where valuation is highly uncertain at the outset, the arrangements that would have been made in comparable circumstances by independent enterprises should be followed. Thus, if independent enterprises would have fixed the pricing based upon a particular projection, the same approach should be used by the tax administration in evaluating the pricing. In such a case, the tax administration could, for example, inquire into whether the associated enterprises made adequate projections, taking into account all the developments that were reasonably foreseeable, without using hindsight.

6.33 It is recognized that a tax administration may find it difficult, particularly in the case of an uncooperative taxpayer, to establish what profits were reasonably foreseeable at the time that the transaction was entered into. For example, such a taxpayer, at an early stage, may transfer intangibles to an affiliate, set a royalty that does not reflect the subsequently demonstrated value of the intangible for tax or other purposes, and later take the position that it was not possible at the time of the transfer to predict the subsequent success of the product. In such a case, the subsequent developments might prompt a tax administration to inquire what independent enterprises would have done on the basis of information reasonably available at the time of the transaction. In particular, consideration should be paid to whether the associated enterprises intended to and did make projections that independent enterprises would have considered adequate, taking into account the reasonably foreseeable developments and in light of the risk of unforeseeable developments, and whether independent enterprises would have insisted on some additional protections against the risk of high uncertainty in valuation.

6.34 If independent enterprises would have insisted on a price adjustment clause in comparable circumstances, the tax administration should be permitted to determine the pricing on the basis of such a clause. Similarly, if independent enterprises would have considered unforeseeable subsequent developments so fundamental that their occurrence would have led to a prospective renegotiation of the pricing of a transaction, such developments should also lead to a modification of the pricing of a comparable controlled transaction between associated enterprises.

6.35 It is recognised that tax administrations may not be able to conduct an audit of a taxpayer's return until several years after it has been filed. In such a case, a tax administration would be entitled to adjust the amount of consideration with respect to all open years up to the time when the audit takes place, on the basis of the information that independent enterprises would have used in comparable circumstances to set the pricing.

D. Marketing activities undertaken by enterprises not owning trademarks or tradenames

6.36 Difficult transfer pricing problems can arise when marketing activities are undertaken by enterprises that do not own the trademarks or tradenames that they

are promoting (such as a distributor of branded goods). In such a case, it is necessary to determine how the marketer should be compensated for those activities. The issue is whether the marketer should be compensated as a service provider, i.e., for providing promotional services, or whether there are any cases in which the marketer should share in any additional return attributable to the marketing intangibles. A related question is how the return attributable to the marketing intangibles can be identified.

6.37 As regards the first issue -- whether the marketer is entitled to a return on the marketing intangibles above a normal return on marketing activities -- the analysis requires an assessment of the obligations and rights implied by the agreement between the parties. It will often be the case that the return on marketing activities will be sufficient and appropriate. One relatively clear case is where a distributor acts merely as an agent, being reimbursed for its promotional expenditures by the owner of the marketing intangible. In that case, the distributor would be entitled to compensation appropriate to its agency activities alone and would not be entitled to share in any return attributable to the marketing intangible.

6.38 Where the distributor actually bears the cost of its marketing activities (i.e., there is no arrangement for the owner to reimburse the expenditures), the issue is the extent to which the distributor is able to share in the potential benefits from those activities. In general, in arm's length dealings the ability of a party that is not the legal owner of a marketing intangible to obtain the future benefits of marketing activities that increase the value of that intangible will depend principally on the substance of the rights of that party. For example, a distributor may have the ability to obtain benefits from its investments in developing the value of a trademark from its turnover and market share where it has a long-term contract of sole distribution rights for the trademarked product. In such cases, the distributor's share of benefits should be determined based on what an independent distributor would obtain in comparable circumstances. In some cases, a distributor may bear extraordinary marketing expenditures beyond what an independent distributor with similar rights might incur for the benefit of its own distribution activities. An independent distributor in such a case might obtain an additional return from the owner of the trademark, perhaps through a decrease in the purchase price of the product or a reduction in royalty rate.

6.39 The other question is how the return attributable to marketing activities can be identified. A marketing intangible may obtain value as a consequence of advertising and other promotional expenditures, which can be important to maintain the value of the trademark. However, it can be difficult to determine what these expenditures have contributed to the success of a product. For instance, it can be difficult to determine what advertising and marketing expenditures have contributed to the production or revenue, and to what degree. It is also possible that a new trademark or one newly introduced into a particular market may have no value or little value in that market and its value may change over the years as it makes an impression on the market (or perhaps loses its impact). A dominant market share may to some extent be attributable to marketing efforts of a distributor. The value and any changes will depend to an extent on how effectively the trademark is promoted in the particular market. More fundamentally, in many cases higher returns derived from the sale of trademarked products may be due as much to the unique characteristics of the product or its high quality as to the success of advertising and other promotional expenditures. The actual conduct of the parties over a period of years should be given significant weight in evaluating the return attributable to marketing activities. See paragraphs 1.49-1.51 (multiple year data).